RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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January 9, 1985 **LETTER 904**

Dec. 28, DJIA 1204.17; PTI 1598; A-D Ratio -20.33
Jan. 4 DJIA 1184.96; PTI 1588; A-D Ratio -20.42

NEW YEAR NOTES: I don't like market formulas. These are the equations which state that if the market does this for the first five days of January, then it will do that for the rest of January, and this and that for the rest of 1985. People don't realize it, but the longer any so-called formula "works," the nearer it is (by the law of averages) to malfunctioning.

Thus we have the old formula which states that the first five days of the new year will set the trend for the rest of January (this didn't work last year). And we have the formula that states that as January goes, so goes the rest of the year (which barely worked last year depending on which index you watched).

One of the more logical items I do monitor is the December low for the Dow, which in 1984 was 1163.21. Very often the December low is set by year-end tax selling, so the December low tends to be a "selling pressure low." I never like it when this December pressure low is broken early in the year, because in the majority of cases this is a sign that something is wrong in the fundamentals. Years when the December low has been broken early are usually rotten years for the market as a whole although even there are exceptions (exceptions 1978 and 1982).

The rally off the 1984 December low was decidedly sub-standard, and this could be a negative omen for 1985 market. The so-called Santa Claus rally hardly appeared last year as the Dow rallied a mere 4% above its December 1984 low by year-end (a "good" rally at year end is 10%).

It is well publicized the secondary issues did very poorly during 1984, but the extent of their performance has not been fully recognized. Consider this: at year-end 1984 the advance-decline lines of both the AMEX and NASDAQ were at ten-year lows. Now that is a really poor performance, and one wonders what that action is telling us. One result of the collapsed A-D ratios has, of course, been huge losses in the secondary issues. For this reason odd-lot selling ratios (i.e., the ratios of selling to buying) were the biggest (during December) in many years with the final days showing selling ratios of four to one over buying.

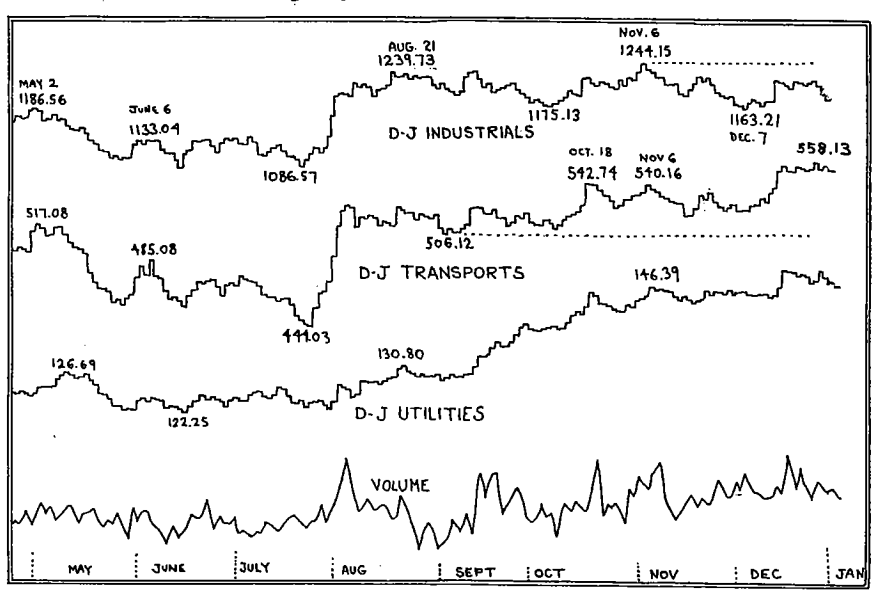
What really did happen in 1984? Here's the answer: DJIA down 3.7%for the year, DJTA down 6.8%, DJUA up 18.4%, S & P 500 up 1.4%, AMEX Index down 8.4%, NASDAQ down 11.2%, Value Line Comp. down 8.4%. All in all, only the utilities and bonds had a good year in 1984. Happily, the item I urged subscribers to buy above all was bonds, so I feel I earned my pay in '84.

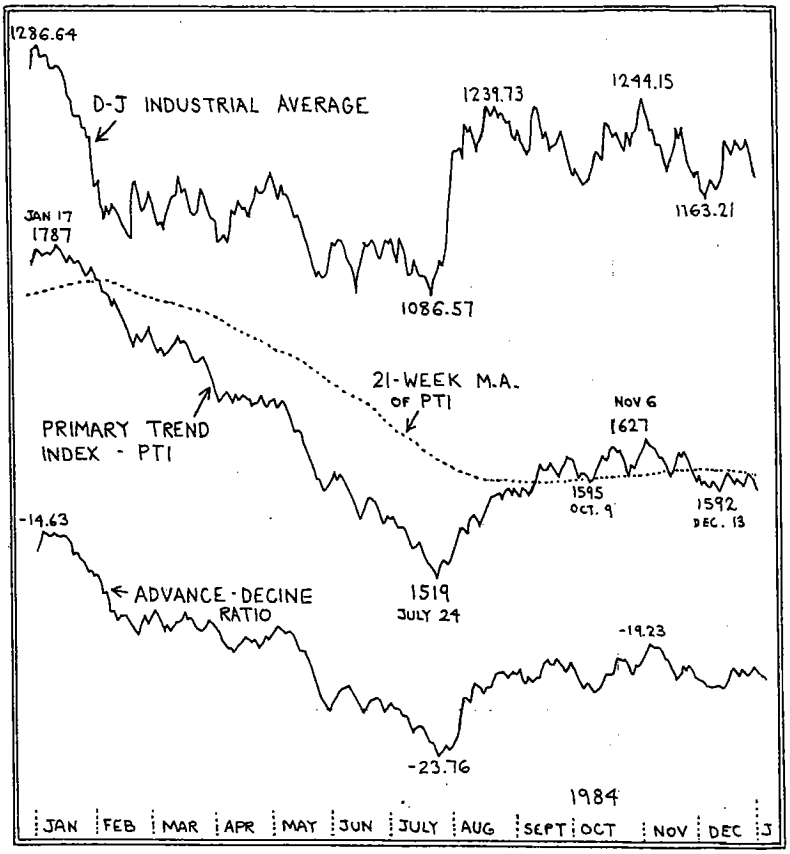
The stock market has assumed the shape of a national guessing game for 1985. At the extremes, Bob Prechter is looking for a massive leg number two for the bull, while on the other side Joe Granville is talking about a bear market and around 600 for the Dow.

Russell, what's he looking for? I'm simply looking for a breakout of the "line" formation in the D-J Industrials and Transports – a breakout one way or the other. I've gone over the line limits many times: They are 1244.15 for Industrials and 558.13 for Transports on the upside. On the downside we have 1163.21 and 506.12. I have no preconceived notion as to which side will win. I'm perfectly happy to let the market tell me the story here in 1985.

My Primary Trend Index (PTI) can be seen on the page 2 chart. It's really been trendless over recent months, and in being trendless it has told the true story of this market. The PTI hit a high of 1627 back on November 6, and that stands as its best effort. I guess I should say that I have not been impressed or encouraged by the PTI action since then.

On December 31 we saw another in the long string of unconfirmed moves in the Averages, this time a new high for Transports unconfirmed by the sluggish D-J Industrials. With all the new options available on various averages, I sometimes think that the whip-sawing action of the last five months is "Wall Street's revenge." Could it be the market's way of punishing the gamblers who are "playing the market" instead of investing? Remember, you can only make money in options if you get a persistent move one way or the other. The markets through most of the last five months gave you neither.





My good friend Marty Zweig notes that with the two recent discount rate cuts, his Fed Indicator has risen to plus 3, and that in all cases since 1936 a plus 3 on his indicator meant a higher market. Thus another faithful indicator will be put to the test.

My own feeling is that federal deficits of $200 billion, a federal debt of $1.6 trillion and a hemorrhaging balance-of-payments may render the standard indicators obsolete. But I'll keep an open mind, and I hope Marty's plus 3 still has market-power.

PERSPECTIVE: With 1984 ending and 1985 beginning, it seems to me that this is a good time to provide a long-term perspective to subscribers. The weekly chart below (courtesy of Ned Davis Research) shows the three D-J Averages (weekly high and low) for the past six years.

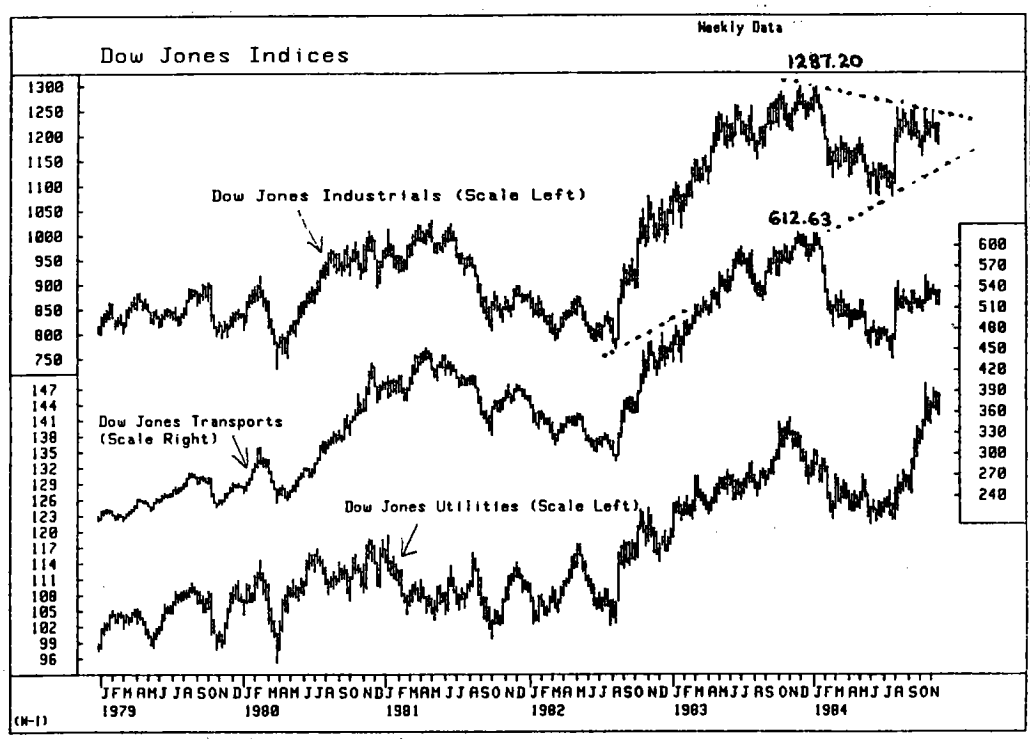
What we see here is a picture of a bull market that has lapsed into an indecisive market. The bull phase is obvious; it started in August 1982 at 776.92 on the Dow. The rise carried on into 1983, and by November 29, 1983 the Dow had risen to1287.20. Five weeks later, on January 9, 1984 the D-J Transportation Average touched a high of 612.63.

From those record highs, the two Averages slid to the 1984 lows recorded in late-July. Next came a one-week surge during August, and from there on it's been a "line" formation in the two Averages.

I have drawn two trendlines for the Industrials. The longer, rising Trendline defines the major bull trend that began in 1982. The shorter descending trendline connects the late 1983 and the lower 1984 tops. The resulting triangle represents thirteen months of pure indecision.

CONCLUSION: We hear all kinds of nonsense from so-called market experts regarding which way the market "must go" in 1985. But the sad fact is that no one man or woman alive – really knows. I will present one observation here: it is unusual during a true bull market for the Averages to end the year at a lower level than the level at which they started. Yet that is the situation that we witnessed in 1984. Does that indicate (or guarantee) that the bull market ended at the 1287.20 and 612.63 high? No, but it's a reason for caution.

Second thought: the advance-decline line topped out in June of 1983. On a trend basis, this line has been sinking (see Letter 902, page 2) ever since the mid-1983 peak. The declining phase of the A-D line has now lasted considerably longer than the rising phase (the rising phase began in June of 1982 and lasted ten months). This is atypical action for a primary bull market.


Weekly Data
Dow Jones Indices
1287.20
612.63
Dow Jones Industrials (Scale Left)
Dow Jones Transports
(Scale Right)
Dow Jones Utilities (Scale Left)
1300 1250 1200 1150 1100 1050 1000 950 900 850 800 750
147 144 141 138 135 132 129 126 123 120 117 114 111 108 105 102 99 96
600 570 540 510 480 450 420 390 360 330 300 270 240
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1979 1980 1981 1982 1983 1984
(M-1)

INVESTMENT POSITION: I wish I could put some kind of animal in this box, but if I did I would just be kidding my subscribers. The Averages are still in an indecisive "line" formation, and the PTI although tipping somewhat to the downside is still not decisively bearish. The fact is that the market has not yet tipped its hand, and Richard Russell doesn't possess the magic formula for speeding up the process. So we wait.

IBM (the market leader) appears toppy, blue chips look a lot better than secondaries, the Utility Average looks strongest of the Averages, and everyone is guessing about when "the second leg of the bull market will begin." Bonds look toppy, and gold is hanging onto 300 by its fingernails.

FUNDAMENTALS: I've been issuing my warnings about this nation's profligate spending (and the resulting deficits) for about five years. I started my warning program back in the late-1970's, and by 1980 I had moved my program into high gear. I stated repeatedly that if drastic measures weren't taken the whole situation would simply go "out-of-control." I warned when Carter came to the Presidency that his first act should be to cut spending and cut it dramatically. I urged that he should warn the nation about the deficits on the day he took office. I repeated this same message when Reagan came to office.

One of the difficulties of the American democratic system is that it doesn't plan – it reacts. And what it reacts to is usually a crisis. The system is huge now, and the opposing factions are many. Therefore, most reactions to emergency take the form of a compromise. That's how and why I formulated Russell's Political Rule, which runs like this. "Politicians do just enough to bring the screaming down to a dull whimper – and that's all."

The financial crisis I've been talking about for five years is just now beginning to hit. Here are the facts: we now have the figures for the first two months of fiscal 1985. The deficit for those two months rose to $57.2 billion, 21% above the comparable two months of fiscal 1984. At this rate the 1985 deficit is going to be well over the $205 billion predicted by the Administration.

Question: Russell, what's happening? Why are the deficits rising above the scary level of 1984?

Answer: Tax receipts are slowing due to the sluggish economy. Also, spending is rising. For instance, government spending for the first two months of fiscal 1984 was $138 billion. For the first two months of fiscal 1985 spending rose to $161 billion, a rise of almost 18%.

Question: What worries you most about the situation?

Answer: My biggest worry is the specter of recession. If a recession does hit, tax receipts to government are going to plunge. On top of that, if there's a recession Congress will resist most spending cuts (in fact, Congress may want to increase spending to stimulate the economy). So a recession in 1985 or '86 could cause the current "over $200 billion" deficit to go out of sight on the upside. That in turn would require a massive increase in government borrowing, and increased borrowing would run interest rates through the roof again.

So the problem is that with the current rate of spending and with current deficits, any recession would accentuate all the problems that we now have to deal with. Just picture the nation sinking into recession in 1985 with the federal deficits rising, with unemployment rising (unemployment costs government additional money) and with interest rates rising. The net result would be the worst of all economic worlds. It's frightening to even contemplate.

Question: Russell, what are the odds on a recession in 1985?

Answer: I think (and this is only my guess) that the odds are about 50/50 that the nation will sink into recession sometime during 1985 (and my guess is for the first half of '85).

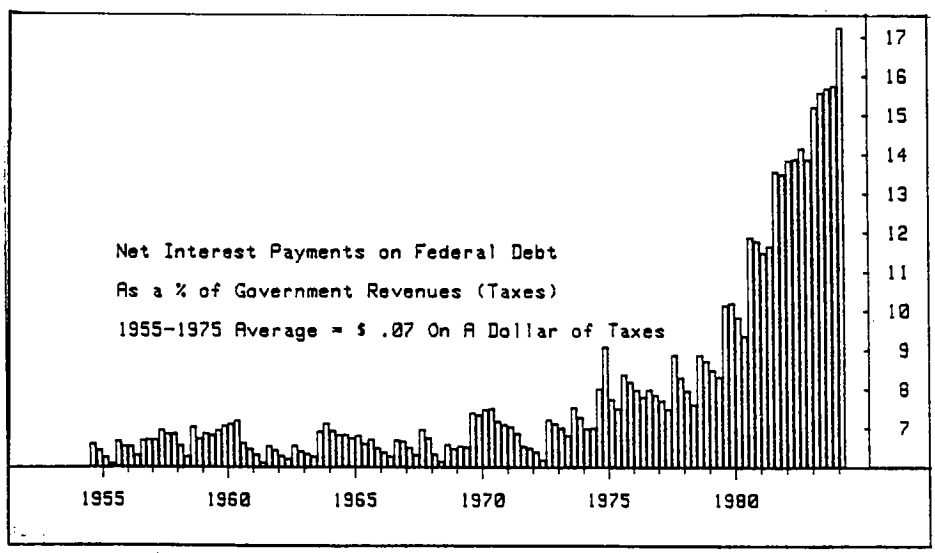
Question: If there is a recession, what do you expect from the Fed?

Answer: Everyone is now screaming at the Fed to "ease up" on the money supply and interest rates. But I think Mr. Volcker is still worried about inflation. Volcker has been fighting inflation and taking a great deal of abuse for his anti-inflation stand over the years. If recession hits and the deficits go off into space, I think that Volcker will resist mightily the pressure for all-out monetization of the debt. If I'm correct, then a recession could bring on new highs in interest rates and deflation rather than so-called "inflationary recession" that so many advisors are predicting.

As a matter of fact, I think gold may now be telling us something important. Gold traders can read the deficit figures as well as you and I. They see the 1985 deficit building. If so, then why is gold sinking to new lows? Why isn't gold taking off as the specter of another deficit of over $200 billion looms into sight? The answer, I believe, is that new highs in deficits are going to push interest rates higher, and higher rates make the dollar more attractive. A still-stronger dollar is bearish for gold, and this is one reason (in my opinion) why gold is now going down.

Question: What about the interest on the federal debt? You've talked a lot about that in the past.

Answer: This is part of the negative compounding problem that I've been stressing. The fact is that compounding deficits have been eating this nation up alive. The latest figures show that the cost of interest on the federal debt was $13.51 billion in the single month of November. Annualize that and you get a total annual cost of $162 billion or $3.1 billion per week. That's fiscal insanity, and we're there NOW!



To illustrate what is occurring, I am including this chart from Ned Davis Research, a chart showing how the interest on the debt is exploding to the point where it is now consuming over 17% of all government revenues.

Question: I see the dollar is hitting new highs against major currencies. What are the implications here?

Answer: The strong dollar makes US goods expensive, and the strong dollar buys foreign goods at bargain prices. Thus, US imports are climbing, while our exports are hard hit. Foreign competition is now probably as rough as it's been in half a century. Many of our major industries such as steel and machine tools are reeling. Even agriculture, our biggest export item, has been hit hard, and if it were

not for unprecedented Soviet purchases, the farm belt would be in a worse depression than it is now in.

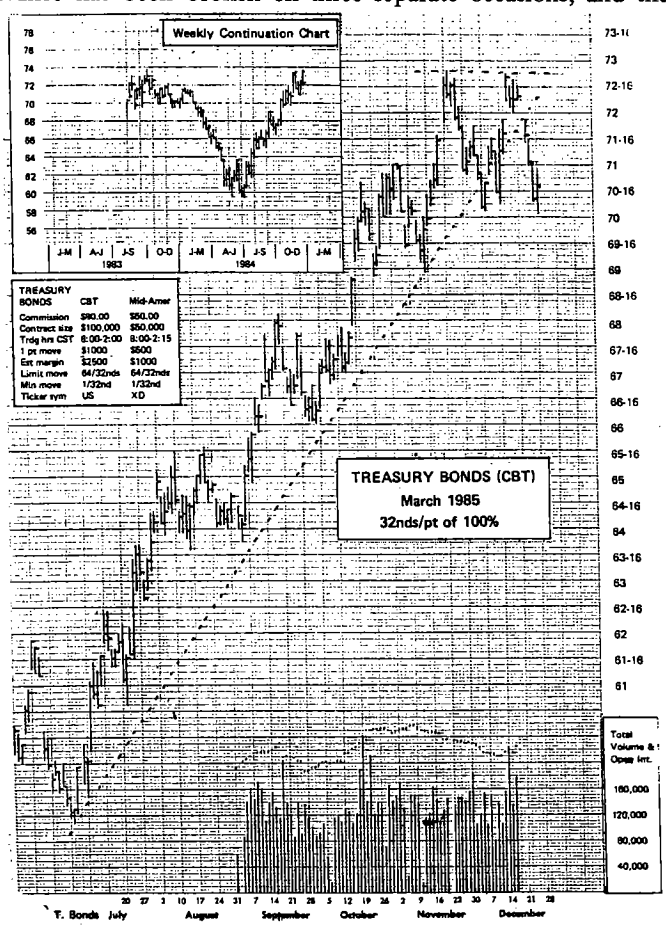
I might add that the Fed and the Administration would love to see the dollar turn weaker – ***but gradually*** weaker. Yet I am afraid that when the dollar finally does turn weak, it will smash. That would bring on a panic to sell US debt securities as foreigners rush to protect their assets from a collapsing dollar.

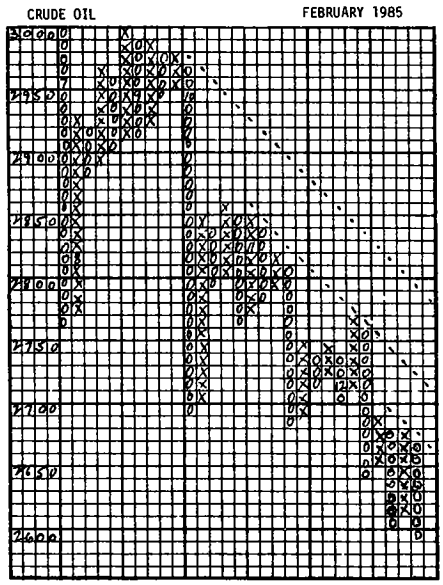
The US's fiscal problems have miraculously been placed on hold by the economy and the markets. But I feel that the string is being pulled tighter and tighter. How it will all work out, obviously, no one knows. Meanwhile, the D-J Averages continue to fluctuate within their five-month "line" formation.

BONDS: There are three non-stock charts that I am watching with particular interest at this time. They are crude oil, bonds, gold. The oil and gold are weak and heading down. The bonds are simply looking toppy. My June call to "buy bonds" has brought me more happy letters from subscribers than at any time since I said "buy stocks" in December 1974. But readers also know that Wall Street is a two-way street, and bonds are no exception.

I have been including a chart of the March T-bond contract in each Letter, and my simple warning has been, "If the March bonds hit 70, that's a sell signal, meaning that the bonds have topped out." Those wishing to preserve fat profits should sell their T-bonds on a 70 signal for the March contract. As for the munis, I'm holding on to mine because I feel they are cheap here regardless of what the Treasuries do.

This chart (courtesy of Dunn & Hargitt) shows a potential double top on the bonds at just under 73. The major trendline for the bond action now is taking place completely below the trendline. A price of 70 will break both preceding December bottoms.





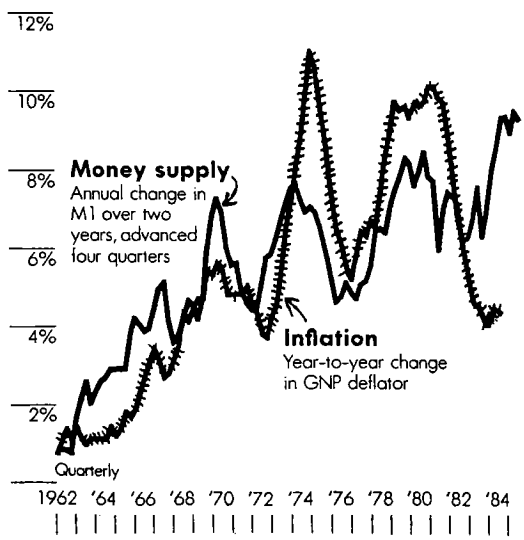
As for the crude oil, this Chartcraft chart shows the oil in a decisive downtrend and looking very weak. Many major US banks have huge loans outstanding based on their original projections of "forty dollar oil by 1990." With oil under $26, you can imagine the white knuckles in banking circles. If oil drops towards $20, I expect we'll see many banks in trouble.

INFLATION? Over the past year I've been pointing to the commodity index and gold as proof that inflation is ebbing and disinflation (or actual deflation) is in the saddle. My gold-to-bonds index has collapsed, indicating that gold (which rises during inflation) and bonds (which rise during deflation) are flashing a decidedly deflationary note.

But as they say, all facts are history. The charts tell us what has happened, and chartists lean on the thesis that chart trends will continue until proved otherwise.

But many leading monetarists now claim that what we've seen so far is simply a pause in a basically inflationary environment. They claim further that the cards are stacked in favor of inflation for the future. This chart (from the January 7 Fortune) accompanies an article by Robert Sinche, chief economist for Bear Stearns. Sinche believes that one of the best measures of money is M-1, and he also feels that M-1 growth leads inflation by anywhere from one year to two years.

If that's true, then the chart shown here is significant. It suggests that we are in the bottoming period prior to the next inflationary rise. Time will tell, but I personally am keeping a totally open mind on the subject.



Writing this month for Stanford Magazine, famed monetarist Milton Friedman seems also to arrive at the inflationary conclusion. States Friedman, "I believe that we have passed the low point in the inflationary cycle, that the widespread belief that inflation is licked is not correct. Inflation is likely to be 6 to 8% by the end of 1985 – not on a year to year basis but from month to month or quarter to quarter. Moreover, a further rise is likely in 1985, so that double-digit inflation is again a real possibility."

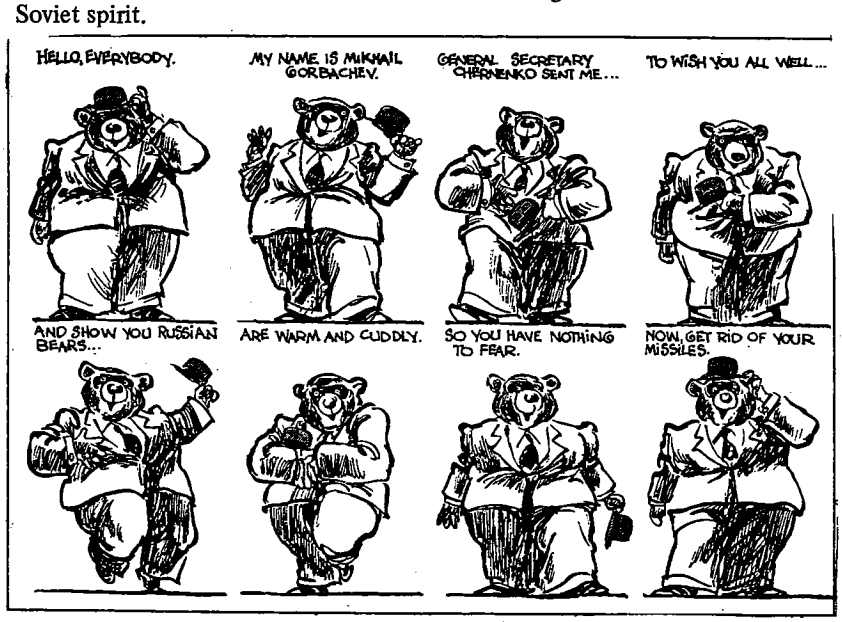
My only comment is that with massive deficit in the neighborhood of $200 billion, the big inflationary question is whether the Fed will decide to monetize that debt – or whether the Fed will make the market buy the greatest portion of that debt (thereby keeping pressure on the bond markets and also keeping pressure on interest rates). As I've been saying for years, the new equation is the rise of the debt monster. And that may throw all previous concepts of inflation into a cocked hat.

NOTES & QUOTES: Almost nothing has been written about this: The Russian government is now confronted with one of the most fantastic ironies of the century. The Free World (particularly the US and Japan) is now deep in the throes of the "information revolution." The KEY to the revolution is the computer with its unbelievable access to information. In the world of the 1990's and beyond it will be unthinkable for an American child to grow up without a knowledge of computers. the computer-ignorant college student will be considered illiterate.

Yet the Russian populace has absolutely NO ACCESS to computers. The Soviet leaders are terribly frightened of a Russian population with the ability to tune in to what's happening via the instant screen of the computer. Yet the leaders know that in the race for world supremacy, Communism has no chance with a population that is totally ignorant of computers. The problem: what to do? The answer: the Russians have no answer. Computers, as far as the Russian citizen is concerned, are a total unknown. Of such are the ironies of history. And this could be the FATAL FLAW in the Russian plan for the ultimate victory of Communism!

* *

The Soviets have the greatest respect for American technology and know-how. Obviously, Russia would like nothing better than to see us bury "Starwars." One cartoonist has caught the "new" Soviet spirit.


HELLO, EVERYBODY.
MY NAME IS MIKHAIL GORBACHEV.
GENERAL SECRETARY CHERNENKO SENT ME...
TO WISH YOU ALL WELL...
AND SHOW YOU RUSSIAN BEARS...
ARE WARM AND CUDDLY.
SO YOU HAVE NOTHING TO FEAR.
NOW, GET RID OF YOUR MISSILES.

Greed or chutzpah! The state of Massachusetts is claiming that the NY Jets owe them for 1/16th of their earnings. Why? Because they played football against the Patriots in 1982, and the state claims that since they earned 1/16th of their year's money in Mass., they owe the state taxes. What happens if you're a salesman and you make a sale in Mass.? I mean, give us a break!

* *

Farmers in California are suffering like farmers all over the nation. There is currently a total US farm debt of $200 billion and with commodity prices way down, the squeeze is on. This is from the December 22 LA Times:

* *

Until now seemingly immune to the dizzying economic ups and downs experienced in other farming states, California is entering its worst agricultural crisis since the dispossessions of the Depression. Farmers such as the Clarks are contributing to a national farm debt that at $200 billion is more than the national debts of Brazil and Mexico combined.

The values of the rich farmlands in counties like Madera and Fresno have plummeted by as much as 70%, and prices for many of California's more than 200 crops have hit rock bottom. A growing number of farmers, unable to convince banks and credit associations to loan them money enough to see them through another year, are walking off their land or being foreclosed on. Not surprisingly, the clusters of "for sale" signs along rural highways have drawn few takers.

"This is the worst I've ever seen it and I've been in this valley over 60 years," said George Schneider,

* *

But all is not rotten in the Golden State. California's 1984 GNP was more than $460 billion, making it the 7th largest economic power in the world. One fifth of the nation's 500 fastest growing companies are located in California, more than any other state.

* *

From Bob Kinsman's Low-Risk Growth Letter (70 Mitchell Blvd., San Rafael, CA 94903):

> Budget Director Stockman's proposed spending cuts of about $42 billion dollars for FY 1986 do **not** mean that total government spending is to be $42 billion **less** than the $968 billion anticipated for the current FY. They merely mean that the **increase** should be proposed as a $42 billion dollar **smaller** increase. The most extreme proposals would only "freeze" spending at the current total. Within that total, some programs would increase and some decrease. Therefore, you can **totally** ignore all the statements and claims about **spending cuts.**

NEW YORK: I have lived in California since 1961. But before that I lived in NYC where I was born and raised. Around New Year's time I start thinking about New York, and to tell the truth there's actually not a day that I don't think about the City. Sometimes my thoughts are grim, sometimes they are happy, and the truth is that I often feel like jumping on a plane and just checking into the City. But I resist, or at least I want to wait for spring when Gotham warms up.

New York has changed dramatically from the years when I was a kid prior to World War II. Then NYC was quieter, less crowded, far cheaper. I remember the Depression in NYC, the apple sellers on the corners, the breadlines, the tin-can huts in Central Park, the Paramount and Frank Sinatra (75 cents for the whole show before 12 noon). I remember jazz in Harlem with Dizzie Gillespie and I remember Billie Holiday on 52nd Street. I saw Babe Ruth hit one of his last home runs at Yankee Stadium and I remember Central Park when it was safe to take a date there after midnight.

But I prefer California now. It's easier and friendlier and I can live two blocks from the ocean. I get the New York Times and WSJ every morning at 4AM, and I get New York Magazine and Interview so I don't miss NYC as much as I used to. In the December 24-31 issue of New York Magazine there is a great collection of pieces by sundry prominent people on their views of the City. Here are a few of those "voices."

I WENT TO LOS ANGELES NOT LONG AGO, and it's like one huge hamburger joint. There's nothing to see there. I couldn't get my body clock adjusted to going to sleep at eleven o'clock at night. But New York is the people's jungle. They made the trees and the grass for animals and nature, but they made the concrete and tall buildings here for society.

—José Torres
Chairman, State Athletic Commission

THE OTHER DAY, I TOOK THE SUBWAY for the first time in years. I usually avoid it because it hurts my ears so much. And I got into one of those mad subway cars with the graffiti all over. It was insanity. People standing there with all this black spaghetti twirling on the walls behind them. I suppose if you wanted to get hot about it, you could say that's the New York art style now. It's okay with me, but I'm not one of those people who thinks it's very meaningful as art. What's interesting in terms of style now is that the city's base is broadening. You have all these people coming here from India, Cambodia, Korea, and other parts of Asia. They've settled here and they work here and they're part of the city. It's a whole different thing that I don't know much about. And as an artist, you have to wonder if your work really speaks to these people, if it reaches them, if you're not being too limited. So that might change the style of New York art.

—Larry Rivers

NEW YORK STYLE IS UNIQUE BECAUSE IT is so completely international.

—Calvin Klein

▼

NEW YORK IS A PLACE WHERE EVEN IF you don't want to get a pizza at three o'clock in the morning, you can still get it. Most of what's new started here. And what didn't start here got better once it came here. I've been all over the country, and wherever I go, I meet people who wish they were from New York.

—Barry Gray

WHAT I SAY ABOUT LOS ANGELES IS THAT if you take away the swimming pools and the tennis courts, it's Iwo Jima. Here, it's different. I have an office in midtown. From there, I can walk to ABC, NBC, CBS, Twentieth Century Fox, Columbia Pictures, and the rest. It's not like having to get in the car to drive to Culver City or Burbank. You have much more concentrated energy here, because everything is so close together. Here, we have meetings. There, they take meetings. Here, we have lunch. There, they take lunch.

The other week I got back from making a picture in London. I had lunch at the Russian Tea Room, cocktails at "21," and dinner at Elaine's. By the end of the day, I knew everything that was going on in the movie business and also in the business world. It's an update of the era when comedians would come off the road and hang around Lindy's for a couple of hours and know everything that was going on. Or you'd hang around the Brill Building for a couple of hours and find out about the music business. I don't think that's really changed.

Los Angeles is a company town. It's very incestuous. Everybody is in the business, and they talk about the business all the time. But, in fact, all the deals are made here, on Wall Street. If you want to talk to Orion about making a picture, you have to come here. The energy is in New York, and people come here to get charged up. But you can get away from all that; I can sit at home on a Saturday here and not be asked what *The Terminator* grossed. You even have a different style of performer here. Who epitomizes that? Ed Koch. The whole "How'm I doing?" bit. Actors have been asking how they're doing since the Greeks. Only in New York, they tell you. New York is the only place in the world where, if you walk on the street the day after a television appearance, they tell you immediately if you were good or if you stunk.

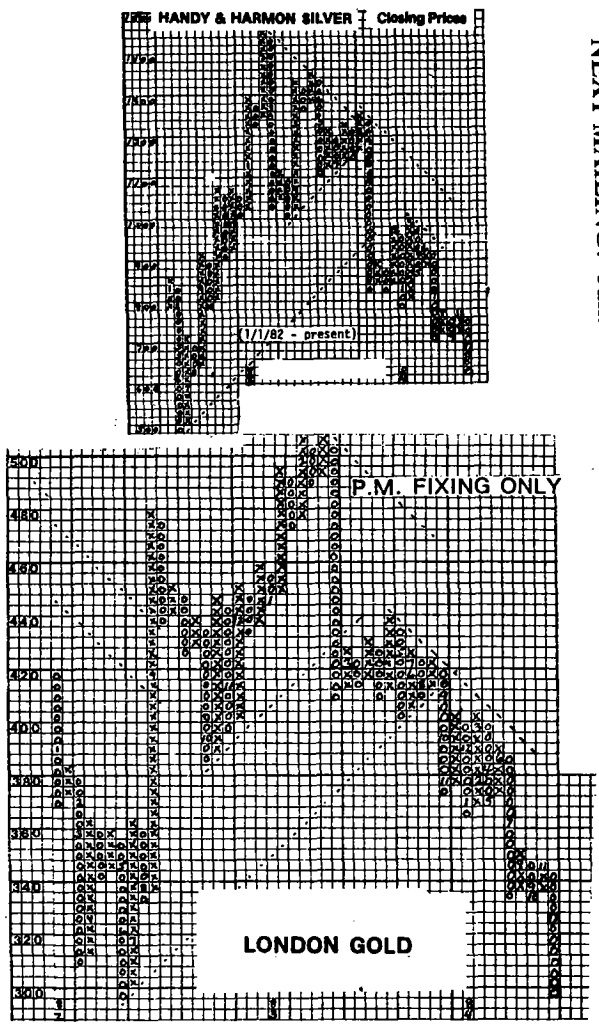
—Alan King

GOLD: On the Financial News TV broadcast (Dec. 31) I took a totally opposing view to Joe Granville on gold. Joe said that he felt gold would rise sharply if the stock market broke down during 1985. I disagreed. I stated that if the market fell apart during 1985, I would take that as a signal for falling corporate profits, recession and deflation. In which case, I would expect gold to crack with the market. I also pointed to the precarious technical position of gold, hovering (as it was) only 10 points above the critical 295 level (see chart in the last Letter).

On January 3 the morning London fix for gold was below 300 for the first time since June 1982. This point & figure chart (courtesy Chartcraft) shows gold rather extended on the downside, but during a bear market the price action can get VERY extended, and that is obviously what has occurred. Note that the 300 box brought in support at the 1982 lows, so 300 (or 295) is a critical area for gold.

As I stated in the last Letter, if gold smashed decisively below 295 I don't see any real support down to 200. I believe that a gold break below 295 would be very serious and a strong signal in favor of the deflation argument. With our government forecasting deficits of over $200 billion out to 1987, anything resembling deflation could be catastrophic.

Speaking of gold, Harry Browne (Box 5586, Austin, TX 78763) in his current report writes an absolutely hilarious parody of six hard-money investment letters. Beg, borrow or steal Harry's Dec. 26 report. If Browne ever decides to write for Hollywood, he'll make two fortunes.



NEXT MAILING: Jan. 23

LATE NOTES: Remember a few years ago when in every Letter I wrote that "The dollar will be king!" Well, it's happening. Bonds, commodities, stocks, gold, silver, real estate, currencies, EVERYTHING has been going down against the great, the all-mighty dollar! The bonds look toppy here, the CRB Commodity index is sinking to new lows, and the PTI looks to be slowly (very slowly) rolling over. On the face of it – it's a deflationary picture. The strength of the whole situation resides in the D-J Transportation Average, so watch this Average carefully (any real weakness in Transports would be very bearish here).

Flash: Lawrence Kudlow, former economist of the Office of Management and Budget sees a 1985 federal deficit of $245 billion (that's a quarter of a trillion dollars!).